Building Bridges between the Poor and the Banking System

A Study of Sanghamithra Rural Financial Services

M S Sriram

Research carried out under the
Sir Ratan Tata Trust Fund for Research Collaborations in MicroFinance
Indian Institute of Management
Vastrapur, Ahmedabad 380015

Phone:++91—79-2632-4855 (O) •2632-5413 (R) • **Fax**: ++91-79-2630-6896
Email: **mssriram@iimahd.ernet.in** • Website:**http://www.iimahd.ernet.in/~mssriram**

Building Bridges between the Poor and the Banking System
A Study of Sanghamithra Rural Financial Services

M S Sriram

Abstract

The paper is about Sanghamithra Rural Financial Services. It traces the growth of Sanghamithra from the time it was conceived till its completion of the fourth year of operations. It maps out how the strategic positioning of Sanghamithra has evolved and responded to external environment. It also traces the reasons for Sanghamithra to re-define its own role.

Sanghamithra represents a unique experiment in the microfinance sector. It has important lessons on how an intermediary organisation can be structured, the impact it could have on the banking system, its own growth and sustainability. It raises issues of structuring organisations and also triggers a debate on whether the intent should be for-profit or not-for-profit. We conclude while the intent is important to choose the form of incorporation, while the nature of activities in itself does not dictate this intent and the consequent incorporation.

We also discuss the issue of taxability. While there are arguments on the "charitable" nature of the operations of MFIs, we argue that these arguments are usually open to interpretation. If an institution has tax-free status as a non-negotiable part of its model, it may encounter regulatory roadblocks. This aspect is to be factored, while examining similar experiments.

The paper also concludes that there is enough scope for an intermediary level organisation such as Sanghamithra to exist given the way the banking system is evolving and given the fairly inelastic nature of demand for credit vis-à-vis interest rates. It appears that access seems to be the prime concern while we deal with rural credit. However the paper recognises that this model is yet to build in a mechanism to collect "savings" of the clients. This is an issue worth pondering while structuring such intermediary organisations.

Building Bridges between the Poor and the Banking System
A Study of Sanghamithra Rural Financial Services

M S Sriram[1]

Background

Sanghamithra Rural Financial Services (Sanghamithra) was promoted by MYRADA an organisation working for rural development in South India. Before getting into the details of Sanghamithra, it may be important to understand the work of MYRADA in microfinance. This gives us a greater understanding of the challenges faced by Sanghamithra. MYRADA is a non-governmental organisation (NGO), which from its inception believed in building linkages between poor, people's organisations, local institutions, state and other NGOs. The mission statement of MYRADA included the following aspect - *to influence public policies in favour of the poor and to build supportive institutional linkages between official institutions and people's organisations* (Fernandez, 1998).

MYRADA was one of the early innovators of the concept of self-help groups (SHG) [2]. The concept emerged in 1984-85, when MYRADA found that the banking system was not able to meet the needs of the poor. The banks were centralised, operated within specific guidelines and could not deal with the small client. That was when MYRADA experimented with SHGs. These SHGs were large enough for the bank to have transactions. The SHGs in turn were also very responsive and flexible to the needs of the members. While MYRADA did not believe in directly intervening in the credit market for the poor, they believed that the strategy had to go one step beyond "banking with the poor". This step was towards "banking with institutions established and controlled by the poor". The SHGs were a step in that direction. From 1984-85 onwards, for almost a decade MYRADA continued with this strategy of marrying the mainstream banking system with SHGs. In keeping with its mission, most of the efforts of MYRADA were in working with existing institutions like NABARD and conducting workshops for bankers on understanding and dealing with SHGs. However, one of the problems that MYRADA constantly faced with the bankers was that there was a sense of disbelief that SHGs could actually work and the banks transacting with SHGs could in fact make profits from this line of business. To counter this skepticism MYRADA had to have a working model that could demonstrate that banking with people's institutions was indeed profitable.

MYRADA also believed that NGOs were not suited to undertake this activity under the traditional form of incorporation as a charitable trust/society. For instance, even as late

---

[1] Faculty Member, Centre for Management in Agriculture, Indian Institute of Management Ahmedabad (IIMA). The research for this case study was carried out under the Sir Ratan Tata Fund for Research Collaborations in Microfinance instituted at IIMA. Contact at mssriram@iimahd.ernet.in.

[2] MYRADA started with Credit Management Groups (CMGs) and then recognizing the fact that these groups were performing a larger role than just credit management started using the term SHG. However, over a period of time, the term SHG got adopted into the mainstream nomenclature as NABARD embraced the concept. But the SHGs around the country as they are known largely perform the role of financial intermediation only. MYRADA believed that the groups promoted by them perform a larger social role and therefore called their groups as – Self-help Affinity Groups (SAGs). However for the purposes of this paper we use the term SHG uniformly. This includes old CMGs and the new SAGs promoted by MYRADA.

as 1998 the stated position of MYRADA was that it would not become a financial intermediary. MYRADA did not attempt to start a "Bank" which sooner or later would take on features that are standardised and centralised due to several factors, including the need to conform to banking norms (Fernandez, 1998). So, in the game plan of MYRADA there were banking institutions at one end providing financial services, and the poor at the other who would be unable to use these services due to inflexibilities in the system. The need was for an intermediary institution that would be flexible at the level of the poor and give a base level of comfort and professionalism to be a client of a proper bank. This gap was to be bridged by the SHGs.

MYRADA identified that forming SHGs having an acceptable transaction size with the bank would not happen naturally. MYRADA believed that some of these costs were to be borne by the society at large – either through the state or through donor agencies. They identified three sets of activities that were necessary to bank with the poor.

1. Formation of SHGs, which had to be initiated by NGOs. Though MYRADA encouraged Banks – particularly the Cauvery Grameena Bank to form SHGs, they believed that the bankers would not have a sustained interest in this.
2. Training of SHGs – also to be done with an element of subsidy, though the subsidy could be graded over a period of time and full costs passed on to the SHGs.
3. Financial transactions – which was expected to be viable and the bankers should be interested in undertaking these activities.[3]

Rationale for establishing Sanghamithra

When the activity of forming SHGs picked up, MYRADA realised that establishing linkage with the formal credit system was not simple. MYRADA identified that the traditional banking system had affected the credit culture in rural areas for three reasons:

1) The bank officials did not have long-term stakes in rural areas. Their orientation was urban. However, this was not the only reason for the poor getting a raw deal for, if this were the case, the urban poor should not have suffered. While the next two points apply to the poor in general, the rural poor were at a double disadvantage.
2) The borrowers were not convinced to maintain the credit-discipline because:
   a) Bankers usually did not ask them to repay a loan
   b) The state had occasionally asked them NOT to repay a loan[4]
3) The average loan size was small, increasing the transaction costs per rupee lent.

These led to a circularity of encouraging non-performing assets (NPAs) and citing NPA as a reason for not undertaking further lending. This led to a situation where,

- there was a demand for credit amongst the rural poor;
- there were resources in the banking system – through refinance schemes and own resources;
- there were regulations directing credit for vulnerable sections overtly through priority sector lending targets and covertly through subsidies; but
- the linkage between people needing credit and agencies supplying credit was failing.

(Sriram, 2000)

[3] Internal note by Fernandez to MYRADA staff dated August 20, 1993.

[4] Fernandez makes a poignant distinction between *sala* (meaning a loan in Kannada, the local language) and the term *loan* used by the poor. According to them, a loan is something that comes from the State and need not be repaid, while a *sala* is something that is borrowed locally and has to be necessarily repaid (Fernandez, 1998).

In addition, MYRADA also questioned its own rationale in wanting to start an independent organisation. The initial design was that if SHGs were formed and linked, the banks would see them as good customers and scale up lending. This was based on the assumption that the number of rural bank branches would expand. However, by 1994 there was a growing realisation within MYRADA that with liberalisation and economic restructuring catching up, there was an increasing tendency to rationalise bank branches and consolidate operations. In this process the physical distance between a SHG and a bank branch increased. Therefore, linking SHGs to banks or having branches focussing on SHGs was not going to happen. The need to set up an independent entity that would bridge this gap was clearly seen[5].

However the concept notes circulated within MYRADA stated that the proposed organisation would not be adding more tiers to the financial structure. The idea was to use this structure only to facilitate the loaning activities. The concept note even said that the financial services from head office to SHGs will be operated through bank accounts.[6]

Later, when Sanghamithra was established, and before it started operations, an internal workshop identified criteria for advancing loans to SHGs. One of the criterion was the SHG should have approached a bank branch with the same request and its application should be pending in the bank for at least four weeks or turned down for reasons that Sanghamithra regarded as inadequate.[7]

Incorporation

Sanghamithra was incorporated as a not-for-profit company in February 1995, under Section 25 of the Indian Companies Act of 1956. The objectives of Sanghamithra were:

1. To work with poor, reinforce their efforts to rise and remain above the poverty line.
2. To provide credit on interest or otherwise, to groups of poor persons who come together on the basis of affinity, both in rural and urban areas with the support of SHG promoting institutions.
3. To create replicable models in the area of financial services for the economically poor and socially exploited sections of the society in rural and urban India.
4. To support the rural and urban poor and to overcome poverty of all kinds (economic poverty, poverty of values and poverty of relationships with the people and organisations) through capacity building, skill development and attitudinal changes.
5. To encourage and collaborate with people and institutions with similar objectives.
6. To collaborate with the state, NGOs and to bring about changes in public policies and practices in favour of the poor and deprived, particularly in the areas of economic, fiscal and social administration.

(Srinivasan, 2003).

Even as it was incorporated and kept distinct from MYRADA, we see that the objectives were more interventionist and developmental than a financial intermediary. To address these objectives, was there a need to establish a new entity? Was it possible for MYRADA to undertake these activities? The answer to these questions is possibly hidden

---

[5] Internal note by Fernandez to the staff dated September 29, 1994.

[6] Puhazhendhi, V (1993) Project Proposal for Establishment of a Financial Service for the Development of SHGs, Internal documents of MYRADA.

[7] MYRADA: Minutes of an internal workshop dated June 20, 1995.

in the second objective. MYRADA did not want to into commercial transactions. Though Sanghamithra was set up with broad brush objectives, the intent was to demonstrate that banking with the poor through SHGs was indeed profitable and sustainable. Therefore an institution having a distinct culture from the parent was necessary. It was a clean way of demonstrating. By keeping the balance sheet separate, the cross subsidization if any, could be avoided. If we look at the microfinance institutions (MFIs) across India, we find that only a few have taken this conscious decision of keeping the financial transactions away in a specialised entity. Usually we find that NGOs slowly get morphed into MFIs over a period of time, and the starting point is the financial intermediation they undertake on behalf of their beneficiary groups.

The next natural question is – why was it set up as a not-for-profit company if it were to demonstrate profitability and sustainability? The answer possibly is in a mix of the following factors:

1. Legally MYRADA could not invest in the equity of Sanghamithra. Therefore capitalising the project would have been difficult as a for-profit entity. The people who conceived this institution were people who had spent a lifetime in working in the non-profit sector and therefore did not want to invest their personal resources in this company, as they were not looking for returns anyway. No external private investor would be interested in investing in a demonstration model, unless of course, the larger plan was to rapidly grow in this direction in the future.
2. Following from the above, funding was sought from developmental rather than commercial sources both for capitalisation and growth. Donor money could only flow in to not-for-profit entities. Sanghamithra was incorporated with zero equity – the liability of the entity limited by the guarantee provided by the promoter-members[8] as against investment of even a token amount of capital.
3. Since this was conceived as a demonstration model, there would be no pressure on aggressive growth plans. Therefore growth rates fuelled by internal accruals were sufficient. The need to access capital markets for growth was not there.
4. Keeping it as a not-for-profit entity avoided a possible strategic drift in the future, where the organisation having tasted early success wants to grow rapidly as a proper financial institution, and losing the initial developmental orientation. The basic objective of MYRADA was only to demonstrate and encourage existing players to participate in banking with the poor; not create parallel systems.
5. The thinking during that time also indicates this: "if the project succeeds and earns surpluses, these could be ploughed into training activities or even into activities required to form groups."[9] This statement turned out to be providential, as the urban programme of Sanghamithra now pays partner NGOs an amount of Rs.5,000 for promotion and linking of these SHGs.[10]

Though Sanghamithra was established in 1995, it started its operations only in 2000. The delay was because of initial hurdles in getting donor money, and later there were

[8] The term "member" is somewhat loosely used in the microfinance sector. Usually it refers to borrowers with current outstandings, and in several cases, borrowers who have been registered by the MFI. However, the term member in the context of a company specifically means a share-holder, who has subscribed to the capital of the company. In case of Sanghamithra, since there is no capital, all the promoters who have given a guarantee would be treated as members. When we use the term member in this paper, we are using the term in the context of a stakeholder-promoter rather than in the sense of a client-beneficiary.

[9] Fernandez AP (1993): Internal note to the staff of MYRADA.

[10] M-Cril (2004): Risk Assessment Report of Sanghamithra Rural Financial Services.

regulatory hurdles. Following a major scam in the financial services sector in 1996-97, the regulations for carrying out the business of financial services by companies were reviewed through an amendment to the Reserve Bank of India Act, in 1997. Based on the changes effected in the Act, companies receiving public deposits and those that were in the principal business of financial services were expected to register with the Reserve Bank of India (RBI). Stringent norms were laid to commence or carry on the business as a Non Banking Finance Company (NBFC). One of the norms imposed were that the companies classified as NBFCs had to have a minimum net owned fund of Rs.2.5 million. This was later increased to Rs.20 million. However Sanghamithra was designed without capital and the only way of achieving these amounts was by plough back of internal accruals. But in the new dispensation, Sanghamithra could not start business and therefore the possibility of internal accruals was almost ruled out.

There was much correspondence between Sanghamithra and RBI on how Sanghamithra – which had "provision of financial services" as a part of its basic objects – should be treated. There was also some correspondence with the Income Tax department on the "charitable status" of the organisation and therefore the applicability of Income Tax.

In January 2000, based on the recommendations of an expert group (NABARD, 1999), RBI issued an exemption for companies engaged in microfinance activities from the registration requirements applicable to NBFCs[11]. The exemption recognised loans to SHGs as microfinance, and also recognised that not-for-profit companies could undertake microfinance activities. Interestingly the exemption did not extend to for-profit companies involved in microfinance. In doing so, RBI obliquely recognized that some types of microfinancing activities could be legitimately recognized as "not-for-profit", and also laid out contours of what could be defined as microfinance. Though this was neither the first recognition nor the last statement on microfinance, it was very significant because it was the first time a notification was issued recognising microfinance activities beyond the traditional SHG-Bank linkage format.

The exemption benefited Sanghamithra. Other players in microfinance were registered as Trusts and Societies and continued to function through this period. However, even after such a major exemption was granted based on a high power committee recommendation, there were hardly any companies operating, using this exemption. Apart from Sanghamithra and Indian Association of Savings and Credit (IASC), there is no microfinance programme worth a decent size being carried out under this norm. Even IASC is trying to establish a for-profit entity as most of its loaning activities go beyond the small loan size specified in the exemption clause. IASC may want to move out because its portfolio is largely in housing and loan sizes for housing are usually beyond the limit prescribed by RBI. However this exemption ensures that microfinance companies fall within certain very limited size and range of activities and therefore have to be isolated examples rather than large replicable models.

Sanghamithra at that time was quite happy with the regulation as it served its objectives. However, they soon discovered the limitation of the regulation, when they tried to move slightly away from their model. Sanghamithra started it urban operations in late 2000. When the urban programme started, the urban unit wanted to explore better ways of reaching out to the clients. Thin included purpose based group lending

[11] Reserve Bank of India (2000): Notification number Ref. DNBS.(PD).CC.No. 12 /02.01/99-2000 dated January 13, 2000.

such as education loan. In addition the urban unit wanted to understand the micro-economics of doing individual loans and also try and change the structure of SHG loans by having DROP loans (deferred repayment of principal)[12]. This meant that Sanghamithra was no longer exclusively working with groups.

The object clause of Sanghamithra stated that they would work only with SHGs. The urban programme necessitated a change in the objects, and Sanghamithra wanted to introduce the following clause:

> "To provide direct finance with or without security, and with or without interest, to the poor, individually and jointly with one or more of others, who are not yet members of the SHGs, but do have, in the opinion of the Company, the potential to be organized into such Groups over a period of time."[13]

However, the change in the objects clause was not permitted by the authorities. The letter stated:

> "… I am to inform you that your application … seeking amendment to the object clause… has since been… considered and I am to state that, the proposed object contemplates commercial activities as that of a NBFC. Your application is therefore rejected."[14]

Therefore it was clear in the minds of the regulator that commercial lending, even if it were for poor was to be carried out by companies that are registered and regulated by the RBI. Since RBI explicitly provided exemption for group based lending, it was okay, but individual lending to a vulnerable group was a problem. Here, Sanghamithra being registered as a company was a handicap. MFIs registered as not-for-profit Trusts and Societies, do carry out activities mentioned in the amendment to the objects clause.

Review of Operations

In over three years of operation Sanghamithra has been able to break even, and make fair amount of profits. It has demonstrated to the banks that dealing with the poor is worthwhile; it has also systematically addressed other issues that have engaged the banks. It has demonstrated that, with appropriate procedures, it was possible to slash transaction costs and still deal with the poor. Within a short time, Sanghamithra has achieved an operational self-sufficiency (OSS) of 132%. If the donor money were to be costed on commercial terms they were still unable to service the capital, with a financial self-sufficiency (FSS) of 86%. However, considering the investments new organisations have to make in initial years, this is a fair figure and it will not be long before Sanghamithra gets this figure up to 100%.[15] It is important to highlight that these returns were achieved after paying bank charges for leveraging the banking infrastructure. If the banks were to do these activities themselves, the costs would be lower. The banks would be absorbing these costs on a marginal basis as the infrastructure would be in place. The cost of funds for banks would be lower than the figures used for Sanghamithra's cost of capital – banks can access relatively low cost deposits – a window not available to Sanghamithra.

[12] Personal note from Ramesh Ramanathan, Vice Chairman of Sanghamithra (2004)
[13] Annual Report of Sanghamithra for the year ending March 31, 2001.
[14] Annual Report of Sanghamithra for the year ending March 31, 2002.
[15] All the figures are based on the Risk Assessment report of M-Cril (2004).

An issue that the bankers were concerned was about NPAs. With a cumulative repayment rate of 98.9%, and a portfolio at risk (PAR) calculated with a conservative overdue cut off of 60 days showing 6.1%, there is reason to believe that this portfolio is performing very well in comparison to what the banks are used to. It is significantly better than the priority sector portfolio performance, and also better than the overall portfolio of the banks. Therefore Sanghamithra addressed two of the three issues that were raised earlier. The only issue that it did not address pertained to the attitude and orientation of the bankers, who come to the rural areas on brief assignments.

Meeting such high performance standards was a result of some important policies and operating procedures that existed within Sanghamithra. We would like to discuss this to examine its replicability in the banks. This will provide explanations on why the banks are not lapping up this market in a way that one would have expected with the performance shown by Sanghamithra and other microfinance agencies.

Sanghamithra achieved the above performance by following some unique procedures including:

1. Identifying the customers:

This was done in close association with local community based organisations (CBOs). These organisations used participatory appraisal techniques in identifying client groups. By collaborating with CBOs, Sanghamithra created an institutional control mechanism. The loan disbursal was done by the SHG through a process of consultation. The involvement of a CBO was crucial because it provided a referral system.

While the process of targeting the ultimate clients was left to SHGs, Sanghamithra did assessments, ensuring the safety of the money being lent. The process was as follows:

- First a CBO introduced the SHG. Based on a visit and appraisal, the credit officer determined and classified the SHG into three categories.
    - Category A: Ready to be linked;
    - Category B: Some parameters have to be met to be linked, but can achieve the standards with some inputs; and
    - Category C: Not suitable for linking at present.
- The category A groups were registered. The advantage of this system was that potential clients got to know where they stood and how they could qualify for linkage. This feedback put the burden of correction on the collaborating CBO. While this feedback was useful, it impaired Sanghamithra's ability to seek and nurture category C clients.

2. Keeping the procedures simple

The procedures followed by Sanghamithra were:

- Introduction by a CBO, visit by an officer for assessment. If the SHG was A category then they passed a resolution and applied for a loan.
- The decision to grant a loan was based on the recommendation and the data given by the credit officer.
- Once the decision was made, cheque was delivered to the SHG by the credit officer.
- The documentation was done at the time of delivering the cheque.

- The interest incidence was from the date of the cheque and not from the date of handover. The date of handover preceded the date of the cheque.
- Keeping documentation simple – the objective of documentation was to establish that the money was disbursed on certain terms and conditions. Documentation was not done with an objective of going to court. Therefore back-ending all expenses pertaining litigation (which would be exceptional) was the strategy. This saved stamp duty on non-defaulting accounts (expected to be more than 98% cases) and in the unlikely event of default leading to litigation, imposed a penalty on those that actually sought legal recourse.

3. Keeping products and repayments simple

The loans were usually in round figures. The terms of the loans were fixed in a manner that the instalments were easy to understand. All repayments were through post dated cheques. However, the contact with the SHGs had to be regular – therefore only two post-dated cheques were taken. Every time a cheque was banked, the SHG was informed to ensure that there was sufficient balance. While this ensured regular contact, it gave flexibility to Sanghamithra to use the cheque on the due date. The principle was to devise a product that could be rolled out fast and could be easily understood.

Impact on the banking system

While the objective of Sanghamithra was to demonstrate that with appropriate intermediary systems like SHGs, banking with the poor was possible, Sanghamithra itself was not designed to be self-liquidating. What would happen if Sanghamithra became successful in its objectives and the banking system took over? The answer is not simple. Sanghamithra may move to other geographies where the banking system had failed. It may reinvent itself as a financial intermediary; it may take up causes other than credit. The objects of Sanghamithra include provision of savings services so that the SHGs find a safe outlet to deposit their savings. Under the current regulation Sanghamithra is prohibited from taking group savings. The SHG model is built on the foundation of regular meetings, with savings providing a purpose for the meetings. Unless the issue of savings is addressed effectively the role of Sanghamithra would never be complete.

Given the demonstration of Sanghamithra, the bankers should have been happy to take the cues and start lending in a big way to SHGs. The demonstration on how the housing portfolio has taken off across the banking system in this country shows that given reasonable assurance on the safety of the loans, the bankers are capable of lending to a segment considered "priority" on pure commercial considerations. Housing falls under the parameters of "priority sector". Several banks like the ICICI Bank have lent far in excess of their target requirements, not because there is pressure, but they see this as an attractive commercial proposition. But did the banks see SHGs as an opportunity, at least in the areas where Sanghamithra operated?

The response to this question is mixed. An impact assessment study indicated that the banks see Sanghamithra as competition and have responded both positively and negatively (Srinivasan, 2003). The positive response was in taking over the groups that were linked to Sanghamithra - offering them better terms. In addition the data indicated that the growth of SHG linkage by these banks was faster after Sanghamithra came into the market. The negative response was by creating hurdles to Sanghamithra. The

greatest efficiency of the chain – from Sanghamithra to the ultimate customers could not be greater than the weakest link. The most important link in the chain, is the banking system as Sanghamithra operates only through the banking system (cheque based transactions rather than cash based). Therefore the banking system could create problems in processing. It was apparent that the banks wanted to compete both in pricing and in relative efficiency.

Sanghamithra should have been happy with this, and should have been moving on to other locations; withdrawing from locations where the banks were active. However, trends indicated that while banks recognised that they were losing out to Sanghamithra, they did not have a plan to pro-actively capture the market. Therefore, it was often found that when Sanghamithra reduced the intensity of its activity, the banks also slackened. This meant that the presence of Sanghamithra was required continually for the banking system to perform.

Is it possible to understand the reluctance of the banks to take on the task of lending to SHGs and ensure that Sanghamithra leaves the field? After all Sanghamithra has demonstrated that the portfolio is attractive, has excellent repayment rates and is cost effective. In fact the banks may be more efficient in costs because they do not have overheads of the channel; they own the channel.

The reason for the banks not taking SHG portfolio in a manner similar to the housing portfolio is to be traced to the nature of physical activity involved. The banks are used to operating from the counters – the activity is centralised. This is so with good reason – banking involves handling large amounts of cash on a day-to-day basis. This needs security and is to be done in a place with adequate infrastructure. The microfinance models, including the SHG models are de-centralised – they reach out to the clients in their setting. This change is a major paradigm shift for the banks. Even if one gets attitudinal changes in the banks, it might not be sufficient because adapting to the methods of microfinance means getting out of the counter. Banks having a diverse portfolio may not afford this change. We have examples like the Oriental Bank of Commerce having a specialised microfinance branch. But it might be difficult to open several such branches; and this may be the exception that proves the rule.

The documentation and loaning procedures followed by Sanghamithra cannot be readily adapted by the banks as they are bound by larger guidelines. There would be need for a general exemption for dealing with microfinance clients for banks to adapt to the types of documentation of Sanghamithra.

The staff of Sanghamithra cost much less than the average cost of bank personnel. This is a reality one has to live with. The only way the bankers can address the issue of costs is by outsourcing microfinance activity. For instance ICICI Bank has been quick to identify this opportunity and have started using institutions involved in microfinance as selling agents for their loans. This is not a model that all bankers may quickly adapt.

Therefore, even though the portfolio looks attractive, it involves a major shift in the operating procedures of the banks. The banks may be unwilling to make the investment in the internal re-orientation. Since microfinance ultimately is a small part of the bank portfolio, it does not make sense for the bankers to make changes in the procedures.

The bank staff get transferred and move from branch to branch and division to division. So the procedures should therefore be easy to adapt and replicated mechanically across a large number of staff members. Unfortunately the procedures of microfinance are so unique that it is difficult to spread it across all staff members. Therefore we find that the success of SHG linkage programme in a given bank is person dependent; not system dependent. Till we can convert the activity to be system dependent, it is difficult to scale up, irrespective of the attractiveness of the portfolio.

This realization seems to have come to Sanghamithra as well; and there is a new enthusiasm within Sanghamithra to grow. For a long time, Sanghamithra did not get an assessment done by a rating agency, did not draw down a loan that was approved by the SIDBI Foundation for Micro Credit (SFMC) and maintained that they keep the portfolio of a reasonable size that makes the banks perform. But, much the way MYRADA discovered that awareness and sensitisation workshops were to be followed by demonstration, Sanghamithra also realised that demonstration had to be followed up by competition.

We have to recognise that there were other changes in the economy. When Sanghamithra started, the interest rates charged to the SHGs were comparable to the banks. It was an explicit policy as Sanghamithra wanted to demonstrate that the model works within the constraints of the banking system where interest rates are decided centrally (Sriram, 2002). However over the past years interest rates have fallen significantly. Sanghamithra did not effect a change in its rates during these years. This meant that Sanghamithra could source commercial funds at a cheaper rate and leverage on the relative inelasticity of interest rates at the SHG level. This helped Sanghamithra to reach out to a larger number of SHGs. Most of the banks still find that SHG as a unit of transaction is much better than individual clients. However, the transaction intensity and the amount of attention to be devoted to these clients is far higher than what the margins justify. If a bank could get a large portfolio of clusters of SHGs through the consolidated outlet of Sanghamithra, it might be worth forgoing the costs and returns of retail, and get lower risk free margins on a bulk transaction. This was what happened. The benefit of lower interest rates resulted in a greater access to loans and the arbitrage margins went to friendly intermediaries like Sanghamithra.

This development was also helped by the relaxation of the policy of RBI vis-à-vis lending to microfinance. The reforms initiated by RBI were on two counts.

1. The interest rates applicable to loans given by banks to MFIs or by MFIs to SHGs/member beneficiaries was totally left to their discretion.
2. The banks were given freedom to formulate their own model[s] or choose any conduit/intermediary for extending microcredit. Microcredit extended by banks to individual borrowers directly or through any intermediary was reckoned as part of their priority sector[16].

Both these encouraged banks to look at organisations like Sanghamithra as intermediaries that help them to build their portfolio on a bulk basis rather than enter

[16] Inaugural address by Shri Vepa Kamesam, Deputy Governor, Reserve Bank of India at a seminar on "Indian Economic Scenario – Yesterday-Today-Tommorrow – Banking-Agriculture-Industry-IT – New Hopes-New Challenges" organized by Telugu Vaibhavam at Hyderabad on September 16, 2003

into small transactions. This also went hand in hand with the banks' own rationalization of branch network and cost and profitability concerns.

Interestingly banks that were enthusiastic in financing Sanghamithra, were not the ones that were competing with them at the local level. There were three strong Regional Rural Banks (RRB) - Cauvery Grameena Bank, Chitradurga Grameena Bank and Adhiyaman Grameen Bank - competing with Sanghamithra in the area. The banks that were willing to fund Sanghamithra's rural operations were Corporation Bank and Canara Bank. These two banks were not the sponsor banks of the above RRBs. The divide between the commercial banks and RRBs was therefore clear. RRBs in the area saw SHGs as their clients, and were competing with Sanghamithra. The commercial banks had other interests and were happy to allow Sanghamithra to get them the portfolio on a wholesale basis.

The question then is why should Sanghamithra continue in an area if banks are willing to lend? Would it not be wiser for Sanghamithra to move to other areas and demonstrate? According to Sanghamithra, the performance of the RRBs did not show enough maturity for them to withdraw. They also felt that the penetration of the RRBs was not sufficient and therefore there was scope for Sanghamithra to co-exist and compete. This was a competition between a non-resident commercial bank shooting from the shoulder of Sanghamithra at a RRB. Eventually RRBs would have an advantage due to their local presence, but they have to make a cultural shift in operating procedures. This could be a long haul.

Plans of Sanghamithra

What should be the strategy of Sanghamithra in the long run? If the gap between the poor and the banking system is expected to continue in various shades for a long time, it may be necessary for them to continue and grow. With the new bottomline orientation it is not clear how the banking system will respond in the long run. If the trends are to be believed, there might be rationalization of the branches, opening up more space for organisations like Sanghamithra.

Sanghamithra did not plan to grow into a financial supermarket. They recognised that their strength was in being small and agile. Therefore, while MYRADA has been thinking of opening more Sanghamithra like companies. Each company would grow up to a portfolio size of Rs.250 million.

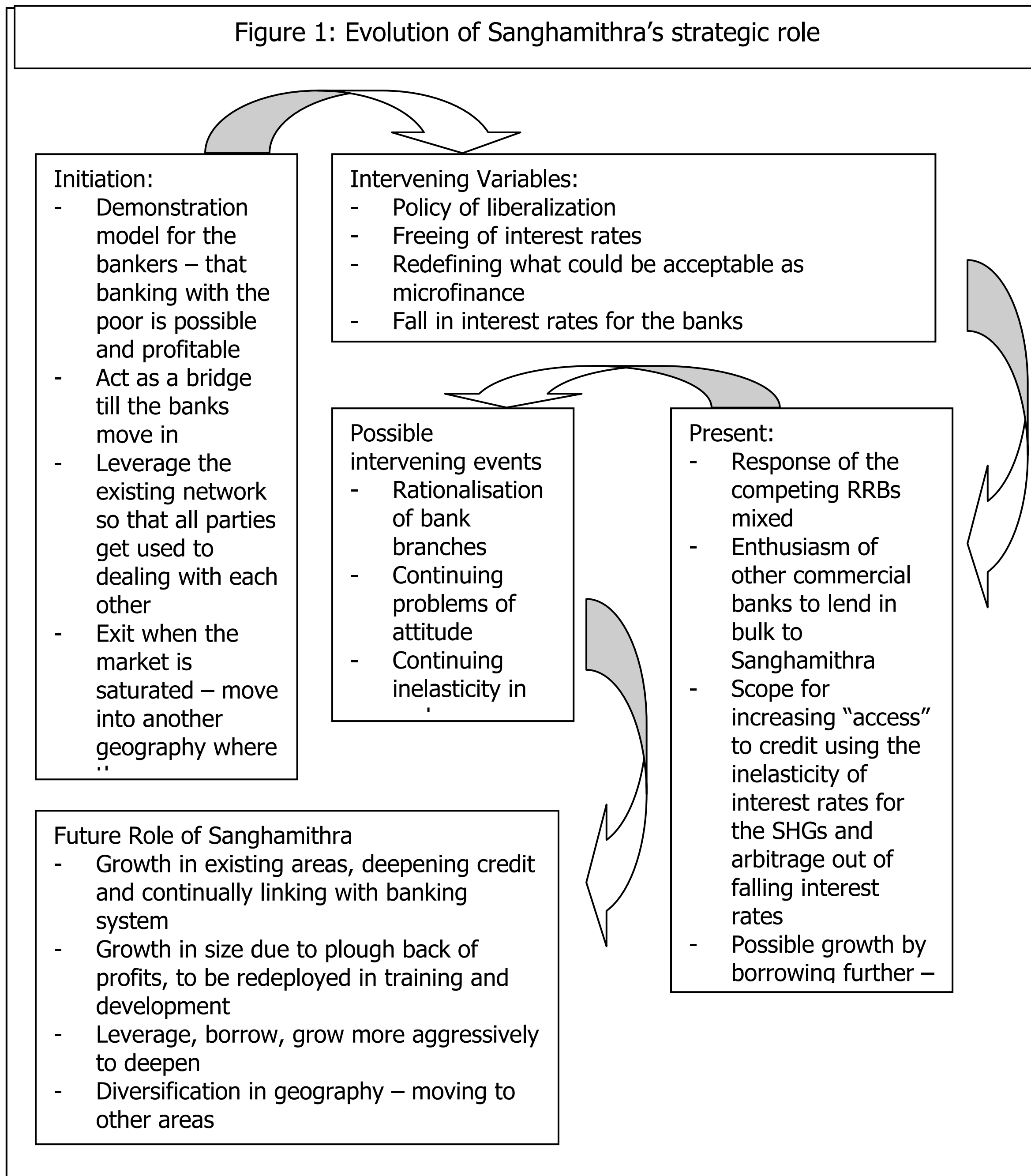
While Sanghamithra has made an intervention in the credit market, there is a larger market of savings that needs intervention. As per the regulations it is not possible for Sanghamithra to do anything now. The SHGs collect savings and use if for rotation. There is no outlet to park idle funds of SHGs except the Banks. In most cases savings precede credit and that is the place where most SHGs in formative stages hit a roadblock. The banks were unwilling to open accounts and SHGs are faced with attitude problems of the bank officials. Sanghamithra has to achieve this breakthrough in future.

The urban challenge is different. While MYRADA and Sanghamithra have a good understanding of the problem of rural credit, the challenge with urban microfinance is different. The banks may not respond in the same manner as the rural banks have

responded. In urban areas, we do not have many neighbourhood banks – though several urban co-operative banks could potentially fit the bill. The commercial banks, particularly the new generation private sector banks, which are willingly lending in bulk to the microfinance sector, are not keen to have the retail clients on their books. The banks have been increasing the minimum deposit required to open a savings account and imposing transaction charges on the customers. This has made small transactions untenable. Therefore the contours of the challenge in urban microfinance are going to be significantly different. Sanghamithra has to cope with it.

Sanghamithra's strategic role over the years is described in Figure 1.

Figure 1: Evolution of Sanghamithra's strategic role



Regulatory issues

Based on the study we discuss issues on regulation that arises out of this model. One question is whether the function of financial intermediation is to be done by not-for-profit entities. While this falls very much in place in the context of MYRADA-Sanghamithra, should this be taken forward as a general principle? What are the merits and de-merits of having not-for-profit entities in financial intermediation?

In the case of Sanghamithra, two issues of regulation were encountered.
1. Recognition as a company engaged in financial services; and
2. Exemption of income tax for revenue arising out of operations.

As a company engaged in provision of financial services – particularly credit to the poor borrowers, Sanghamithra was no different from any other financial institution. The basic parameters of financial institutions are that they get money from certain sources – usually equity and borrowings. The borrowings are further classified as borrowings from institutional sources such as banks and from retail sources such as individual depositors. The money thus obtained is deployed as loans to the poor, for infrastructure and for expenses. The money deployed as loans is then recovered with interest or service charge, and the liabilities are eventually discharged. Inherently there is no element of "charity" involved. It is just a question of whether the interest/service charge levied is reasonable or not. The reasonableness is determined in the context in which the organisation is operating. Therefore strictly speaking it does not matter whether the form of incorporation is actually "for-profit" or "not-for-profit".

However, the edifice of regulation by the central banker – the RBI – is based on the premise that parties interested in earning a margin and also enhancing value to the investors. Here, financial transactions of a large number of people are involved and the transactions happen on a sustained and continual basis. This is unlike other businesses where the transaction terminates on the sale and settlement of an exchange. This could be a one-time transaction. The financial institutions therefore need greater regulation.

Regulation at a broad level would be to look at stability of the organisation to have ongoing transactions. If the financial intermediary is involved only in loaning activities, and is sourcing funds from institutional players, the risk to the deposits of the retail depositor is non existent. Therefore the amount of regulation required here is lower. The success of the business and the safety of the funds of institutions depend on the financial intermediaries like Sanghamithra making appropriate commercial judgements on loans to be given and a follow up to collect the loans. Therefore the regulators have felt that the stakes of the investors have to be at a certain level, to ensure that they have sufficient amounts of their own resources at risk. This is translated into the norm of capital adequacy. This ensures that the promoters do not leverage themselves and put other people's money at stake, while their own losses could be minimal.

At a broad level, when a financial intermediary is sourcing funds only from institutional players, the assumption is that these players are mature enough to take an informed decision on lending to the intermediary. However, if there are a large number of small depositors at the retail level putting in money, then they as a body cannot exercise

effective control or take informed decisions because of their size. In such a situation the role of the regulator is enhanced.

In case of Sanghamithra, the problem was peculiar. It was possible for them to organise a company without any financial stakes of the promoters. This was because anybody could set up a not-for-profit company to undertake developmental activities. The companies act also did not specify a minimum capital – therefore the liabilities of the members of Sanghamithra were limited by guarantee. Now, if such a company wanted to do financial intermediation, is it qualified under the general commercial norms? Obviously not. The issue is again not whether the ultimate returns were to be distributed to the members or not. The issue was whether the stakes of the members of the company was sufficient enough for them to leverage external borrowings. Since not-for-profit entities, having very low capital operating in the arena of microfinance was common, RBI had to take a view on this. The teport of the task force (NABARD, 1999) and its recommendation for review of policy, came in handy for RBI to specifically exempt certain types of organisations from adhering to the rather stringent norms applicable to companies undertaking financial intermediation. Therefore RBI had to have distinguishing markers for what it would define as "microfinance". A convenient marker that the RBI found was that microfinance institutions usually dealt with groups and not individuals. This was sufficient for them to use as a distinctive feature from individual based money lending models that were to be regulated. It suited Sanghamithra because this was the model that they were following. It only posed a problem when Sanghamithra wanted to try individual lending. Here they could not get their objects clause amended to lend to individuals and at the same time enjoy the exemption from the regulation applicable to finance companies.

While there is evidence to the contrary where organisations having very low capital base, depending largely on donated/borrowed funds having done very well and grown – it would be still desirable as a general principle to have capitalisation norms for the financial structure to ensure a minimum involvement from the promoters. We shall deal with the issue of how organisations promoted by developmental professionals who do not have access to commercial capital elsewhere.

The issue emnating from the above discussion is that the ultimate objective of whether the organisation is structured as "for-profit (distribution)" or "not-for-profit" is not germane for doing financial intermediation. However, as a matter of general principle, structurally it is necessary to maintain promoter stakes and ensure capital adequacy.

The second issue is pertaining to taxability of the income. This is a larger issue and here the "commercial" nature of activity comes into play. What is commercial, therefore largely turns out to be a matter of interpretation. One school of thought refers to the possibility of distributing profits, or residual claims to the members of the organisation. The other more conservative view is whether the inherent activity is "charitable" or "commercial" in nature. One of the arguments laid out by an advocate commissioned by Sanghamithra was that the tax status is to be established by the criteria on whether the organisation is serving to obtain private profit. He had argued that there is no need to exempt an organisation that makes no income… and therefore by the very nature of granting explicit exemption, one is recognising that income is accruing, but tax is not being imposed. His opinion was that as long as the organisation does not distribute

dividend, and as long as all property is used for charitable purposes as laid out be the objects of the trust, there should be no doubt about the exempt status of the organisation for the purposes of taxation[17].

While the argument was tenable, it took some effort by Sanghamithra to convince the tax authorities, before they could get an exemption. This exemption was obtained before RBI defined what microfinance was for its regulatory purposes. Now that the RBI definition of what could be construed as microfinance being readily available, the taxation interpretation may also follow suit, but we have to recognise that this is still an issue that officers of the income tax department might interpret either way.

Concluding Notes: Implications for scaling up and replication

How is the Sanghamithra model useful to us for large scale replication of microfinance in India? This question helps us to focus and decide if the strengths were specific to the promoters of Sanghamithra or if they were system driven. Conceptually, this model followed logic. It did not believe in replicating structures, used existing structures and encouraged banks to actively participate in building linkages with the poor. It acted as an intermediary demonstration model. Since it was not-for-profit, there was scope to plough back residual revenues for the development of new groups, expand and deepen the client base. However this model was based on the assumption that NGOs would be interested forming SHGs and linking them. Fernandez has explicitly stated that "formation of groups cannot pay for itself.. these interventions therefore will have to be provided by NGOs….".[18] One could therefore say that if NGOs are willing to bear the cost of investing in groups, the model should be able to run on its own steam. This also precludes the banks promoting SHGs under the assumption that the process of SHG formation and training is intensive if quality was to be achievee. There are arguments that the cost of SHG formation has to be paid by the bankers and it could be recovered in due course, but MYRADA's did not believe so.

The second issue is of intermediation by an institution like Sanghamithra. It is evident from their performance that there was space for an intermediary organisation that could pay for itself. The question of whether this should be membership based or externally induced is open. Possibly there is scope for a federal organisation of the SHGs to eventually operate in the place of Sanghamithra. That form is left to individual preferences, but it might be difficult for other promoters to get a tax-exempt, microfinance company to operate, since a part of whether certain objects of the entity are tenable as charitable activity or not, are tax exempt or not are subject to open interpretations. The precedence of Sanghamithra can be used by other organisations.

[17] Sarangan, G, 1994: Note to MYRADA, internal documents of MYRADA.
[18] Fernandez, 1993: Internal note to staff of MYRADA.

References

Fernandez, AP (1998): The Myrada Experience: Alternate Management Systems for Savings and Credit of the Rural Poor. Second Edition. Bangalore: MYRADA.

NABARD (1999): Task Force on Supportive Policy and Regulatory Framework for microFinance –Summary and Recommendations. Mumbai: NABARD

Srinivasan, Girija (2003): Impact Assessment of Sanghamithra – Draft Report. Bangalore: Sanghamithra (mimeo)

Sriram M S (2002) Case Study of Sanghamithra Rural Financial Services, in Datta, Samar and Sriram M S, *Flow of credit to small and marginal farmers in India,* Ahmedabad: Indian Institute of Management (mimeo).

Sir Ratan Tata Trust Fund for Research Collaborations in Micro finance

Micro finance has been widely acknowledged as a tool for mobilising the poor and reaching quality financial services. The field, especially in India, has developed largely based on practitioner experience. While the sector has expanded, largely through replication, over the past few years, there has also been an increased realisation on limitations of micro finance. The Sir Ratan Tata Trust Fund for Research Collaborations in Micro finance at Indian Institute of Management Ahmedabad (IIMA) supports cutting-edge, field-based research, which reviews and guides experience, especially in the Indian context. The project envisages work on diverse themes such as:

- Understanding financial flows of the poor over long horizons
- Understanding financial flows of seasonal migrants
- Documentation of transformation experiences of Indian microfinance institutions
- Documentation of the role of mainstream banks in microfinance.

Research in progress is put out as working papers. Completed research would be published as papers and books. In addition there would be dissemination through focussed workshops and training programmes for the practitioners.

The Sir Ratan Tata Trust is a grant making foundation with interests in the thematic areas of education, health, rural livelihoods, arts and culture and enhancing civil society and governance. (www.srtt.org)

IIMA is a leading management institute which offers postgraduate and doctoral programmes in management. In addition to research in mainstream areas of business and industry IIMA also undertakes extensive work in social sectors such as agriculture, education, public systems and infrastructure. The SRTT Fund is hosted in the Centre for Management of Agriculture at IIMA. (www.iimahd.ernet.in)